IN THE

Supreme Court of the United States

OCTOBER TERM, 1943

No. 362

THE HIRSCH IMPROVEMENT COMPANY,

Petitioner,

—*v.*—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF

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Law Brief Press—NYC

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To the Honorable Justices of the Supreme Court of the United States:

Your petitioner, the Hirsch Improvement Company, respectfully represents and petitions as follows:

Summary Statement of the Matters Involved.

The petitioner seeks review of the decision of the United States Circuit Court of Appeals for the Second Circuit (L. Hand, Chase and Frank, *JJ.*), affirming on June 5, 1944, (R 262) a decision of the Tax Court of the United States entered on November 21, 1942, finding that there are deficiencies in

income and excess-profits taxes for the calendar year 1936 in the respective amounts of $8,230.33 and $5,939.95.

The case involves two issues, namely:

1. Pursuant to the terms of a twenty-year sublease of a store building, the petitioner, as lessor, in the taxable year 1936 received from its sublessee the sum of $35,000.00 as security for the payment of rent and the performance of the covenants and conditions of the lease. In the event of default by the lessee or termination of the lease prior to its expiration date, the said security was to be retained by the petitioner in payment of its damages. If the petitioner's damages were less than the security the surplus was to be returned to the lessee. Otherwise the petitioner was to apply said sum on account of rent and other payments to be made by the lessee for the last year of the term of the lease.

The Commissioner of Internal Revenue included the $35,000.00 in the petitioner's taxable gross income for year 1936 and was sustained in his action by the Tax Court and the Circuit Court of Appeals.

The petitioner contends that the $35,000.00 was a security deposit which should not have been included in its income for year 1936.

2. The petitioner owned a sublease on a building in Cleveland, Ohio, which it had leased out in its entirety to two tenants. Upon the facts hereinafter set forth the Commissioner of Internal Revenue determined that the petitioner was carrying on or doing business within the meaning of Section 105 of the Revenue Act of 1935, and that it therefore was subject to declared value excess-profits tax for year 1936. The Commissioner's action was sustained by the Tax Court and the Circuit Court of Appeals.

The petitioner contends that the determination is not in accord with the applicable decisions of this Court.

The Statutes and Regulations.

REVENUE ACT OF 1936:

"*Sec. 21.* 'Net income' means the gross income computed under section 22, less the deductions allowed by section 23."

"*Sec. 22.* 'Gross income' includes gains, profits, and income derived from * * * rents, * * *."

"*Sec. 41.* The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but, if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *"

"*Sec. 42.* PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

"The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *"

REGULATIONS 94:

"*Art. 41-1. Computation of net income.*—The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. * * *"

"*Art. 41-2.* * * * All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order to clearly reflect income such amounts are to be properly accounted for as of a different period."

REVENUE ACT OF 1935 (as amended by Revenue Act of 1936)

"*Sec. 105(a)* For each year ending June 30, beginning with the year ending June 30, 1936, there is hereby imposed upon every domestic corporation with respect to carrying on or doing business for any part of such year an excise tax * * *."

"*Sec. 106.* EXCESS PROFITS TAX

"(a) There is hereby imposed upon the net income of every corporation for each income-tax taxable year ending after the close of the first year in respect of which it is taxable under section 105, an excess profits tax equal to the sum of the following:

"6 per centum of such portion of its net income for such income-tax taxable year as is in excess of 10 per centum and not in excess of 15 per centum of the adjusted declared value;

"12 per centum of such portion of its net income for such income-tax taxable year as is in excess of 15 per centum of the adjusted declared value.

"(b) * * *. For the purposes of this section the net income shall be the same as the net income for income tax purposes for the year in respect of which the tax under this section is imposed, computed without the deduction of the tax imposed by this section. * * *."

EXCESS-PROFITS TAX REGULATIONS (T. D. 4666)

"*Art. 2. Scope of Tax.*—The excess-profits tax, imposed by section 106 of the Revenue Act of 1935, as amended, is imposed upon a certain portion of the net income of every corporation for each income-tax taxable year ending after the close of the first year in respect of which the corporation is subject to the capital stock tax imposed by section 105 of that act."

REGULATIONS 64 (1936 EDITION)

"*Art. 43.* * * *

"(b) *Exceptions.*—Ordinarily the exceptions to 'doing business' are restricted to limited activities of a corporation, such as—

* * * * *

"(2) the distribution of the avails of property and the doing only of such acts as may be necessary for the maintenance of its corporate status in the case in which the corporation either was organized for, or has reduced its activities to, the mere owning and holding of specific property."

The Facts.

The petitioner's books are kept and tax returns filed on a cash basis (R. 32).

During year 1936 the petitioner was the owner of a 99-year lease dated April 16, 1915 covering certain property in Cleveland, Ohio, known as the Argyle Block (R. 33). On or about February 27, 1936, the petitioner subleased a portion of the premises to McCrory Stores Corporation, the agreed terms of which were as follows: the lease was to cover the period from June 1, 1936 to December 31, 1955; the lessee agreed to deposit with petitioner the sum of $35,000.00 in cash as security for the rent and performance of the conditions of the lease, such sum to be applied under certain conditions as rent for the year ending December 31, 1955; the rental agreed upon was $30,000.00 per annum for the first seven years of the lease and $32,500.00 per annum thereafter; and the lessee proposed to anticipate the rental to the extent of $2,500.00 per annum for ten years, so that $25,000.00 would be received upon execution of the lease, thereby reducing the rental to be reserved in the lease to $27,500.00 per annum for the first seven years, $30,000.00 per annum for the next three years, and $32,500.00 per annum for the balance of the term. The lease was executed on February 27, 1936, and the rental as stated in the lease was $25,000.00 in cash on the signing and delivery thereof, $27,500.00 per annum for the first seven years of the term, $30,000.00 per annum for the next three years, and $32,500.00 per annum for the balance of the term. In addition the lease provided in a separate paragraph as follows:

> The lessee has, on delivery hereof, paid to the lessor the sum of thirty-five thousand dollars ($35,000), the receipt of which is hereby acknowledged, as security for the payment of rent and the performance of the

covenants and conditions of this lease on the part of the lessee to be performed. It is understood and agreed that the lessor shall apply said sum on account of the rent and other payments herein provided to be made for the year ending December 31, 1955, except that in the event of default in the payment of rent or in the performance of the material and important covenants contained in this lease on the lessee's part to be performed, and the termination of this lease pursuant to the terms hereof prior to January 1, 1955, in which event the said security shall be retained by the lessor in payment of or on account of such damages as the lessor may sustain by reason of the termination of the lease because of the default on the part of the lessee. In the event such damages shall be less than the amount paid as such security the surplus, if any, shall be paid to the lessee, by the lessor (R. 40, 143-146).

The lease also provided that in the event the demised premises shall be destroyed or so seriously damaged by fire or otherwise as to require rebuilding, and if petitioner should be unable or fail to rebuild the premises so as to be ready for occupancy within six months, the sublessee might at its option terminate the lease and upon such termination "all rent paid in advance shall be equally apportioned and the unearned portion refunded to Lessee" (R. 154, 155). It was further provided that if the whole or any part of the premises should be taken by condemnation petitioner would have the right to terminate the lease, in which event "any rent paid in advance shall be prorated and rebated," but that if only a part of the premises were so taken and petitioner did not elect to terminate "proper adjustment in the rent shall be made based upon the amount of square footage taken in said condemnation as against the amount of square footage hereby demised, and Lessor shall refund to Lessee

the proper proportion of any rent of that part of the premises so taken as has been paid in advance, * * *" (R. 157, 158).

McCrory Stores Corporation agreed to pay to petitioner one-half of all taxes and assessments levied upon the premises of which the demised premises formed a part, together with one-fourth of all premiums for fire and/or lightning insurance (R. 148, 149).

In accordance with the provisions of the lease, the petitioner on March 2, 1936, received from McCrory Stores Corporation the sums of $25,000.00 and $35,000.00 (R. 40). It did not report the $35,000.00 as gross income for the tax year, and reported only a portion of the $25,000.00 item. The Commissioner included both the amounts of $25,000.00 and $35,000.00 within petitioner's gross income. The petitioner has conceded that the $25,000.00 item was taxable income in its entirety in the tax year, but contends that the $35,000.00 security deposit should not be included in income for year 1936 (R. 41).

The petitioner was incorporated on March 16, 1922, for the purpose, as stated in its articles of incorporation, "of acquiring, owning, leasing, improving and developing real estate; constructing and maintaining buildings thereon; leasing and operating the same; mortgaging or otherwise incumbering the same and doing all things necessary and incidental thereto" (R. 32, 33).

The actual purpose for which the petitioner was organized was to acquire from Paul Hirsch, one of its stockholders, the 99-year leasehold on the Argyle Block which he owned (R. 233). This lease was assigned to the petitioner two days after its incorporation (R. 33). On March 21, 1922, the petitioner executed a new sublease of the entire premises to The Hirsch Company, the then occupant of the premises, for a term of twenty years, commencing March 1, 1922, at a rental of $50,000.00 per year (R. 33).

On March 24, 1924, the petitioner executed a sublease of the same premises to McCrory Stores Corporation, for a period of ninety years commencing April 1, 1924, at an annual rental of $67,500.00 (R. 34).

From 1924 to 1933, McCrory Stores Corporation was the sole tenant of the taxpayer's leasehold. Since 1933, that company has occupied only a portion of the premises, by reason of the fact that it went into a bankruptcy reorganization proceeding, and the remainder has been sublet to Robin Redbreast Hosiery Co., Inc. under a lease for a period ending June 30, 1945 (R. 233).

Since its incorporation, the petitioner's income has been derived from its leasehold and it has never acquired any other property (R. 233). Its cash receipts during the period July 1, 1935 to June 30, 1936 consisted of rent and three payments made by McCrory Stores Corporation, making a total of $205,000.00 (R. 164, 165). The three payments by McCrory Stores Corporation consisted of the $35,000.00 security deposit and $25,000.00 advance rental hereinabove mentioned, plus the sum of $90,000.00 received in settlement of a claim which the petitioner had filed against McCrory Stores Corporation in bankruptcy (R. 165).

The petitioner's cash disbursements during the period from July 1, 1935 to June 30, 1936 aggregated $183,000.00, consisting chiefly of approximately $30,000.00 as ground rent, $15,000.00 as taxes and insurance, $105,000.00 as dividends and advances to shareholders, $4,000.00 as commissions, $1,200.00 for traveling expenses, bookkeeping and sundry other expenses, the greater part of which were incurred in connection with the settlement with McCrory Stores Corporation, and $18,000.00 as legal expenses connected with the said settlement and the execution of leases. Petitioner paid no salaries to its officers or directors during the said period (R. 166-168, 235).

In the tax year, effective September 1, 1936, the petitioner employed a bank in Cleveland as its agent in the collection of rentals and the payment of the ground rent and taxes due from petitioner (R. 233, 242-246). Any balance of income remaining was to be disbursed by the agent on the petitioner's written instructions (R. 242-246).

During the period July 1, 1935 to June 30, 1936, petitioner did not supply heat, light, water, or janitor service to its two tenants. It made no repairs to the premises. It did not buy, sell or exchange any assets (R. 234). During this period time and effort were required in securing the settlement with McCrory Stores Corporation (R. 235). The lease to Robin Redbreast Hosiery Company, Inc. was executed on July 1, 1935 (R. 235). The board of directors held three special meetings between July 1, 1935 and June 30, 1936, and these were the only formal directors' meetings that were held (R. 45). No formal meeting of the stockholders was held during that period (R. 45). The Robin Redbreast Hosiery Company, Inc. covenanted in its lease to keep and maintain the premises demised to it, including plumbing and electrical fixtures, elevators, etc. in good condition and repair (R. 126). Petitioner covenanted to make all necessary repairs to the roof and sidewalk adjoining the premises (R. 127). McCrory Stores Corporation covenanted in its lease to keep the interior of the premises demised to it in good repair, including the store fronts, show windows and the entrance way; and petitioner covenanted to keep the exterior of the premises, including sidewalk, in good repair, and to carry insurance against fire and/or lightning (R. 147, 151). Similar covenants regarding repairs were contained in the prior lease to McCrory Stores Corporation and in the original lease to The Hirsch Company (R. 46-52, 69-95).

Petitioner reported an excess profits tax liability of $5,369.23 for the year 1936 which it paid together with its

income tax in three installments on June 15, September 24 and December 11, 1937 (R. 41). On March 15, 1940, it filed claim for refund of the excess profits tax so paid upon the ground that it was not engaged in carrying on business during the period July 1, 1935 to June 30, 1936, and therefore was not liable for capital stock tax or excess profits tax (R. 42).

On or after August 13, 1940, the Commissioner mailed to the petitioner a notice of deficiencies in Federal Income and Excess-Profits taxes for the calendar year 1936 in the respective amounts of $17,014.24 and $7,310.72. In arriving at the said deficiencies the Commissioner among other things, determined that the $35,000.00 received by the petitioner as security in year 1936 under its lease to the McCrory Stores Corporation was income to the petitioner and that the petitioner was carrying on business during the period from July 1, 1935 to June 30, 1936 and was therefore subject to declared value excess-profits tax (R. 22-27).

On November 11, 1940, the petitioner filed a petition with the United States Board of Tax Appeals appealing from the deficiency set forth in the notice of deficiency aforesaid. On November 10, 1941, the petitioner filed an amended petition, alleging among other things that the Commissioner, in adjusting the petitioner's net income reported for the calendar year 1936, had erroneously added said $35,000.00 security deposit to the petitioner's reported net income and that the Commissioner had erroneously determined that the petitioner was engaged in carrying on business during the period from July 1, 1935 to June 30, 1936 and was subject to the declared value excess-profits tax (R. 4-21).

On October 6, 1942 the United States Board of Tax Appeals entered its memorandum opinion, wherein it upheld the Commissioner's said determinations (R. 180-200).

On November 21, 1942, the Board entered its final order of redetermination, wherein and whereby it ordered and de-

cided that there are deficiencies in income and excess-profits taxes for the calendar year 1936 in the respective amounts of $8,230.33 and $5,939.95 (R. 201).

The petitioner thereupon appealed to the Circuit Court of Appeals for the Second Circuit, which Court affirmed the determination of the Tax Court (R. 202-214).

The Opinions Below.

The Tax Court's Memorandum Findings of Fact and Opinion are set forth in the Record at pages 180 to 200.

The decision of the Circuit Court of Appeals was promulgated on May 19, 1944 (No. 55), and is not yet officially reported. (55-361)

The Circuit Court of Appeals held that the $35,000.00 was income to the petitioner primarily upon a determination that it was to be repaid under circumstances which might never occur. This determination is in conflict with decisions of another circuit on similar facts and does not give due effect to the contractual intention of the parties to the lease that the money was paid and received as a security deposit which could not become rental income, if at all, until some future date.

The Circuit Court of Appeals further held that the petitioner was doing business in 1936, upon the basis of its opinion in *New London Northern R. R. Co.* v. *Thomas S. Smith,* 141 F. (2d) 219. This decision is in conflict with applicable decisions of this honorable Court.

Jurisdiction.

The Jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925, c. 229, §1 (43 Stat. 938), 28 U. S. C. A. §347 (a).

Questions Presented.

1. Was the $35,000.00 security deposit received by the petitioner in year 1936 taxable gross income within the meaning of the Internal Revenue Laws and the intent of Congress?

2. Under the facts in this case, was the petitioner during the period from July 1, 1935 to June 30, 1936, carrying on or doing business within the meaning of Section 105 of the Revenue Act of 1935, so as to subject it to declared value excess-profits tax liability under Section 106 of the Revenue Act of 1935, as amended by the Revenue Act of 1936?

3. Is the petitioner entitled to a refund of the excess-profits tax paid by it for year 1936 in the sum of $5,369.23, plus interest thereon?

Reasons Relied on for the Allowance of the Writ.

The Circuit Court of Appeals has decided an important question of federal law which has not been, but should be, settled by this Court. The unsettled state of the interpretation of the taxing statutes as applied to money received as a security deposit under the terms of a lease is clearly illustrated by the following conflicting decisions of the Circuit Court of Appeals:

> *Clinton Hotel Realty Corp.* v. *Commissioner,* 128 F. (2d) 968, decided on June 27, 1942 by the Circuit Court of Appeals for the Fifth Circuit;
> *Warren Service Corporation* v. *Commissioner,* 110 F. (2d) 723, decided on March 25, 1940 by the Circuit Court of Appeals for the Second Circuit;

Astor Holding Co. v. *Commissioner*, 135 F. (2d) 47, decided on April 27, 1943 by the Circuit Court of Appeals for the Fifth Circuit;

Commissioner v. *Lyon*, 97 F. (2d) 70, decided on May 27, 1938 by the Circuit Court of Appeals for the Ninth Circuit.

A definite determination of whether and when a security deposit should be included in gross income is of the utmost importance to innumerable real estate owners and lessors, who are daily confronted with this problem. The conflict of opinion on the question directly affects the provisions of leases now in force. The unsettled state of the interpretation of the law has caused confusion among taxpayers who await clarification of the issue.

The determination of the Circuit Court of Appeals on the "doing business" question is in conflict with the weight of authority and applicable decisions of this Court. This Court has held that the mere receipt of income from property leased and the distribution thereof among the corporation's stockholders does not constitute doing business. The Circuit Court's determination that the petitioner was doing business is erroneously based upon the petitioner's activity in protecting its leasehold investment. The nebulous state of confusion existing in the numerous recent decisions require that this Court settle the question.

If, as we urge, the decision of the Circuit Court of Appeals is erroneous, undue prejudice will result to many taxpayers unless the applicable principles are settled by this Court.

WHEREFORE, petitioner prays that a writ of certiorari may issue out of and under the seal of this Court, directed to the United States Circuit Court of Appeals for the Second

Circuit, commanding that Court to certify and send to this Court for review and determination, as provided by law, this cause and a complete transcript of the record and of all proceedings had herein; that the order of the United States Circuit Court of Appeals affirming the decision of the Tax Court of the United States may be reversed; and that petitioner may have such other and further relief in the premises as this Court may deem proper.

Dated, August 16th, 1944.

ELLIOT A. DAITZ,
Counsel for Petitioner.

I HEREBY CERTIFY that I have examined the foregoing petition for a writ of certiorari and that in my opinion it is well founded and the cause is one in which the petition should be granted.

ELLIOT A. DAITZ,
Counsel for Petitioner.